Stranded Gas Hearings
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Tariff Rate-Making: Getting It Right
Robin Brena, Partner, Brena Bell & Clarkson, June 17, 2004.
John Carruthers, Vice President, Northern Development, Enbridge
Jack Crawford, Executive Vice President and Chief Operating Officer, Alliance Pipeline

MR. ROBIN BRENA, Partner, Brena, Bell & Clarkson, P.C., thanked the chair for his introduction, but said he left out the most important part – that he is from Skagway. He stated that he represents Tesoro, Anadarko and Agrium, but he is not representing anyone today and wants to give the committee his opinion on this topic as a citizen.

> It goes without saying that the vast majority of our resources and our wealth are going to flow through pipeline infrastructure that is monopoly infrastructure. It's absolutely essential to our economic future that this monopoly infrastructure has just and reasonable cost-based rates. Rates in excess of that will result in less development of our resources, less revenue from the resources we do develop and fewer opportunities for manufacturing and value-added jobs in Alaska.
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> This is something that you've got to get right. I am here today to encourage the state to act to insure that cost-based just and reasonable rates are established for this pipeline infrastructure now and into the future and anything that you can do to help that, I think, would be good.
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> I have sat through many of the presentations, as you've heard and, were I in your position, I would consider myself to have been 'technocrated' to death. So, what I'm going to try to do is try to bring this home in real dollars and cents and real issues that I think, as a legislator, you should be concerned with in the forming of policy. I thought I'd begin with what the true cost is of not getting this issue right – of not establishing just and reasonable rates. The example that you were encouraged by several participants to consider was an example from history, which is TAPS. It's the first time around, it's a large project; it has a great many similarities to the process. And so, what are the lessons of TAPS?
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> To date, the TAPS carriers have charged and collected transportation rates that are $12.5 billion over just and reasonable rates. They have charged and collected and earned an additional $10.1 billion in excess of just and reasonable DR&R rates. If you only consider the transportation over-collections of $12.5 billion, the impact to state revenues is $8.5 billion. Framed somewhat differently, our Alaska Permanent Fund, if rates were just and reasonable on TAPS, we'd have $8.5 billion more in it today, if the state would have got this issue right. It would have a balance of $36.5 billion instead of $28 billion. That is what many of the technical analysts have told you. You've heard it in bits and pieces and percentages, and please ask me to defend those calculations at some point. I would be more than happy to. With regard to the transportation rate, it was simply done. The RCA has done a comprehensive review of the rates on TAPS. The chair at the time, Thompson, presented to you. She referred you and offered you copies of Order 151, docket P974. In that docket, the commission held that the TAPS carriers had over-collected these amounts of money. All that I've done is take the amounts that the RCA has said is over-collected and plugged in what is the Permanent Dividend annual return - if those funds had rather than being collected by the carriers had not been collected by the carriers. That's 10.3 cents and I contacted the Permanent Fund and got their rates of return for the past 20 years. So, that number is real.
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> The state got it wrong on TAPS and it's cost us $8.5 billion. Let's get it right this time. There's no excuses for not getting it right this time. To understand how to get it right, you have to understand how the state got it wrong. So, I want to talk about some of these concepts.... If you have an alignment of ownership between production and transportation so that people are paying

themselves the tariff rate, then they will charge the highest possible tariff rate they can, because they save a quarter in royalty and severance taxes on every dollar they over-charge themselves. So, their incentives will be to have the highest rates possible while holding their costs down. So, where the rubber meets the road is: what is the return component - because the return is they don't have to pay it, they just get it and they save a quarter in taxes for every dollar they over-charge from the state. They also save money because they make that excessive profit from independents that need to use this monopoly infrastructure. So, there is a huge incentive for the producers to own and to control this line and to manage the ownership structure so it stays perfectly aligned with the production interests – and to transfer profitability from their production into their transportation. That is what has happened here. That is the game that is afoot and that is the game that we haven't figured out yet, well enough.

Let me say, too, that [tape ends]

MR. BRENA explained that oversight of regulators didn't work, because the reality of regulatory practice is that someone must ask them to regulate or they will not. All the shippers will be affiliated with the producers and their incentive will have the highest rates. Most shippers will ask for reasonable rates and that leaves only the state or small independents. It's difficult for small independents to carry the ball. He illustrated his point by saying that he represented a client in a rate case and won; the rate was set through negotiation at about $1.25, but his client can no longer ship on that line. The producers will only sell oil to his client at the end of the line.

It's tough for them to get the oil, because they rely on the oil. It's tough for them to stay on the line if the producers don't want to sell it and allow them to ship it. It's tough because the small independents need cooperation in the field and with the transportation infrastructure in order to survive here. So, don't rely on the small independents carrying the water for the state; the state has to do it.

MR. BRENA said the state settled on the TAPS project and it should have litigated. Many of the assumptions in the settlement were proved wrong, but the settlement didn't have a re-opener clause; so, there was no opportunity for the state to come back in and get something that was fair. He summarized how he thought the state should try to get things right on slide 5.

- Establish clear goals. Ratemaking is not complex and a transparent informed process among all the participants is necessary.
- Properly staff and resource the litigation effort.
- Maximize the state's leverage – the state needs to win a rate case once in a while.

Back to the subject of establishing clear goals, MR. BRENA said cost-based, just and reasonable rates are very simple.

When it costs somebody to build something, you give them their investment back. Until they get their investment back, whatever their investment is, they get a reasonable return on it. They get to recover their operating costs and a tax allowance. And, that's it. Rates should be based on the cost of providing service.

He cautioned that the first question to be asked with any settlement or any proposal is: Are the rates just and reasonable, cost-based rates? Business people don't want to know the rate will be $1; they want to know the rate will stay linked to the actual costs.

Fair terms and conditions for access for future independents is a major consideration. Independents always come to the party later and develop the marginal fields. They will need access to the infrastructure on a forward-going basis. If the major producers lock the transportation and can control access, the independents will be squeezed out. He encouraged the Legislature to do what it can to encourage transparency of the process and include all financially interested parties. "Everybody needs to be at the table." MR. BRENA said Professor Witherspoon, one of the foremost experts on pipelines in the nation, drafted the enabling legislation.

I don't think it's fully appreciated that you are negotiating matters with companies that have more sophistication and greater incomes than most nations. You need to recognize that. So, please devote the resources equal to the task and recognize the task or the cost will be at another $8 billion or $10 billion ten years from now.

Recognize you're negotiating and litigating with certain disadvantages. Like it or not, the state is a political process and there are opportunities to influence the political process that don't go the other way with the other negotiated parties. So, it's important because of your disadvantages in this process to have it be an open process. I think the state should focus on maximizing its [negotiation] and litigation leverage and you have huge amounts of it.

On slide nine, you are the owner of the resource. You can put anything in the lease that you want. It's your oil; it's your gas. If there are games being played that you can't figure out the solution for downstream – if there's not enough tankage to get our resources to the market for fair prices, if there's a bottleneck in transportation and monopoly profits being realized, if the independents can't get the access to field facilities because they aren't able to negotiate cost-based use of field facilities – those are three major bottlenecks that the state will have to deal with in terms of future public policy. All you've got to do is put a sentence in your lease.

The right-of-way. You're the owner of the transportation corridor. That sentence could be under right-of-way. This infrastructure crosses state land. You have tremendous authority and control over the circumstances under which that is used. Your taxing authority and I won't emphasize that, but I would hate to negotiate with someone that had the power to tax me. I would not assume I was in a position of strength in that situation. You have the power to tax.

The power to regulate.... I was very interested in the chair's question from an earlier speaker with regard to state ownership and whether state ownership is appropriate or not. The important thing isn't whether the state owns or doesn't own it, setting aside financing opportunities that may exist for a state-owned facility. The issue is whether or not the production interest is aligned with the transportation interest. If, to use an example, BP as a producer has to pay TransCanada or me if I own the pipeline, then you can bet that rate is going to be just and reasonable. If it's not, BP will go to FERC and get a just and reasonable rate. So, you have control over what the ownership structure of this pipeline should be. Let's say, for example, you decide you want a third-party owner of that pipeline. If you are able to get third-party ownership of that pipeline, then those rates will be just and reasonable, because then the producers will have a huge incentive that they be just and reasonable and they will beat down FERC's doors getting a just and reasonable rate.

Avoid litigating against the state's own interests. I'm litigating against the state, I'm trying to get just and reasonable rates for instate shippers and the state is opposing me at every step of the way. The positions they are taking are compromising and undermining their ability to negotiate good settlements and to litigate good settlements in the future. It doesn't make any sense.

Avoid compromising state authority. Last year, you had an opportunity to take a look at HB 277. I can't imagine a more broad-scaled give-away of the state's own authority to regulate these issues than was proposed through HB 277. Please do not compromise your authority – and understand something about your regulatory authority. As Professor Witherspoon drafted the legislation, what he intended is the state have the power that the federal government didn't have. There was no gap between the two. That may be very, very important to you in the future – that there's no gap between the two.

MR. BRENA said the FERC can't force extension or expansion of the pipeline, but the local commission can.

If the federal government doesn't have the authority, under your current act, the state does. That's very, very important. That was very well conceived and thought-out by the Legislature and Professor Witherspoon. Please don't compromise away your own leverage to negotiate and litigate better deals for the state!

Next, win a rate case. You know, if the state's going to run with the big dogs, it has to have more than a bark and the state has never won a rate case. At some point...if you're not able to win in litigation, you're not able to get a good settlement. If the settlement is before a litigation victory, then it's a bad settlement; it's costing you money. In the last settlement, the state knew that. There wasn't a secret about it. The assistant AG said we think we can litigate and get $2.5 billion more out of this deal than what we can get, but we can't get a better deal through settlement. So, they took the settlement anyway. Well, fairly compare the cost results in efficiencies of settling with litigating. I realize it's popular to bash attorneys; I realize it's popular to say that litigation is something that should be avoided. Well, 20-years ago you avoided it. You had $35 million into litigation, largely on the wrong issues – I just throw that in as an aside – and you settled. It cost you $8.5 billion. Everyone is trying to avoid litigation. What for? Why didn't you litigate that to its end? I hope I'm not back 10 years from now talking to a different legislature with a similar message. Don't just assume that settlement must be done. In these circumstances, it has proved to be the worst result in almost every settlement for the state that I've reviewed with regard to rate transportation. I have felt, without exception, that a litigated result would have been far favorable.

The ratemaking strategy that the state is faced with is to make regulation as difficult as possible for as long as possible until the state settles with them. Let me tell you, for example, the last 79 rate filings on the TransAlaska Pipeline system have been rejected as inadequate or not supported – the last 79! All right? They're not trying to get it right. The local electric company in Skagway makes filings to support its rates every three or four years. They get it right; they know - what we call it a 275A filing – it's what you're supposed to file with your testimony to say what your rates are supposed to be. Every small utility and bush company in this state with 5 or 6 employees gets it right. The last 79 filings on TAPS haven't met that minimum standard. They're not trying to get it right. So, don't underestimate the successfulness of not meaningfully participating in the ratemaking process - dragging it along until the state finally settles.

Finally, if I were you, I would like to know what to look for in a future settlement that would come before me, so I just thought I'd tell you.

Indications of a bad settlement – rates are not determined based on standard ratemaking principles. As soon as people start talking about rates different than just and reasonable rates or rates based on the cost of service, then you've lost. It's just a matter of trying to figure out how much and you'll never figure out how much.

Future access is somehow limited so the people that come late to the party can't get in the party. The people that come late to the party are the people that the state needs to develop their marginal fields and outer fields. They're the independents. After the big puddles of oil and gas are gone, they are the people that are left here developing our marginal fields. If that future is that the infrastructure is controlled by the majors, then the independents are who you're relying on for the exploration, then the state will lose.

Return is not based on investment. Actually, in the TAPS, they gave them a return that was unrelated to investment. Five years before I filed a protest on TAPS, the rate of return on equity for TAPS was over 100 percent per year for the last five years, because it wasn't linked to investment.

Long-term agreements with no re-openers, if their assumptions prove false – I put throughput down there. When you build pipelines, you don't know how much of the resource is really there. So, you need to admit to yourself that you don't know. You also need to admit to yourself that you know less than the people you're negotiating with about what's there. Once you admit those two things, then you're on the way to realizing the limitations that if there are throughput assumptions that go into setting those rates, that if they go out and develop three or four times more resource, that that three or four times more resource isn't flowing through at those set rates because that will result in exorbitant returns. So, if there is a settlement, be sure that it can be reopened if it's needed. If the assumptions prove false - and the state has essentially taken itself and TAPS out of the litigation for 25 years - that's the reason why it's gotten so out of kilter. Many of the assumptions that were made are false and throughput was one of them.

> If the settlement that comes before you is so complex that it takes a team of experts a long time to explain it, ratemaking is not complicated – not withstanding you sitting through two days of less than pleasant comment. If you don't understand it, then it's because it's a bad deal. It's not because you're missing something. If the settlement trust process was not transparent, if other parties didn't participate, if certainty is confused with predictability - and that goes back to my earlier point that if you see any kind of set rate rather than a methodology, then you've lost. Then, if what you hear when it's presented [is] the limitations, costs and risks of FERC litigation - FERC litigation is not difficult. FERC has done a lot to streamline its process. It would take 18 months to two years for a rate case on this pipeline to go through and one of the things that people continue to confuse is that it matters what FERC's opinion is. The D.C. Circuit really establishes ratemaking principles, not FERC.
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> So, the question is how is the settlement consistent or inconsistent with the ratemaking authority that the D.C. Circuit has established that it will use to review FERC.... So, don't have overstated to you the costs or limitations of FERC litigation. Every once in a while, go find out. For a $10 million check, you can go set a just and reasonable rate at FERC in a two-year process and that gives everybody a tremendous amount of predictability because you then will have established what the ratemaking principles that will govern this line through its life will be. One of the real problems with settlement is that you never really know how that line is going to be regulated and oftentimes complex settlements deviate so much that they create their own problems if greater problems than standard ratemaking were allowed to continue. Those are my comments and I'd be happy to answer any questions I can.

CO-CHAIR SAMUELS thanked Mr. Brena for his presentation.

CO-CHAIR OGAN considered Mr. Brena's allegations that the state had been overcharged $12 billion to be serious and asked him to explain what he meant.

MR. BRENA replied that he didn't intend it as an allegation, but the Regulatory Commission of Alaska (RCA) sat through weeks of hearings and Order 151 shows, on a year-by-year basis on spreadsheets, that the over-collections were $9.9 billion through 1996. He added investment return to that - had it not been overcharged. The over-collection happened when the state settled by signing a bad deal when it should have litigated.

CO-CHAIR OGAN said while he appreciated Mr. Brena's testimony, it might throw a wet blanket on the enthusiasm of people investing in Alaska. He has told investors the best way to avoid this type of thing is to have clear and concise rules upfront.

MR. BRENA agreed and said he thought getting terms and conditions right in the first place would result in greater investment in the state, not less. Tilting the cost of the pipeline infrastructure so that there are excessive returns for it would drive out the independents. The best public policy for the state to adopt is to make sure that the people who build the line get their costs back for building it, get a reasonable return for investing in it and get their cost of operation, which they are entitled to under just and reasonable rates. If they got more than that, it would discourage investment. Fair rules for everybody encourage more investment.

SENATOR DYSON commented that the state needs the best consultants to negotiate with these oil companies that are the biggest corporations employing the best minds in the world.

MR. BRENA emphatically agreed.

SENATOR HOFFMAN stated that the industry should not view this hearing as a wet blanket because they are talking about the state's resources and legislators need to make sure they are maximized.

CO-CHAIR SAMUELS said the point is to educate legislators with a variety of ideas and to expose the public on the complexities of this issue. He mentioned there would be another hearing in July with entirely different points of view.

MR. BRENA said he would be happy to discuss these ideas with anyone if the legislature thought that would be helpful.

CO-CHAIR OGAN said he favored an alignment between the state and producers with an independent pipeline and both would be interested in having the lowest tariff possible. He thought that would bring the best netback.

MR. BRENA cautioned that there would be many opportunities for misalignment.

> You don't need complete misalignment, you just need sufficient misalignment so you have a major shipper who has an economic incentive in a just and reasonable rate and that can be a single shipper. For example, when BP and Arco merged, Arco's interest was allowed to be acquired by BP. If it weren't, BP would be TAPS' major shipper and there would be just and reasonable rates on TAPS. I just used the merger as an example. A condition of the merger could have been that Arco's interest was acquired by a third-party. Then the state would not be losing $100 million a year right now.

CO-CHAIR SAMUELS thanked Mr. Brena for his testimony and invited Mr. John Carruthers, Vice President, Northern Development, Enbridge, to testify next on how he would move forward on a business plan.

MR. JOHN CARRUTHERS, Vice President, Northern Development, Enbridge, said he wasn't going to forward a proposal, but would reinforce the idea that there are some options for the state to consider. Enbridge has had some success with incentive tolling in Canada in terms of aligning pipeline companies with shippers. Pipeline companies want to maximize revenue, but not at the expense of shippers. Obviously there has to be a fair allocation of costs based on risk assumptions. Shippers often want to align the pipeline companies with incentive at as low a cost as possible.

MR. JACK CRAWFORD, Vice President and Chief Operating Officer, Alliance Pipeline, added that in terms of alignment, he realizes that almost all cost issues are related to capital costs and it's very important to control those. Historically, a regulated pipeline company has the incentive to spend more money because it makes money on what it spends. So, it makes sense to focus attention at the outset on the capital costs. As a consequence, the arrangements that Alliance put in place had incentives to control capital costs. He didn't know if the same incentives would be appropriate here because the risks are different.

> It is pretty much a risk-allocation-type procedure.... It's probably premature to forecast how that might look given there is still a number of factors that are not settled in terms of how the risk would be allocated in the future.

MR. CARRUTHERS added that companies with experience in building pipelines in the Western Canadian sedimentary basin are apt to take more risk in terms of building something if they had done it before. "It's more difficult in Alaska, because there hasn't been an underground pipeline built...." The Alliance pipeline might be able to take more risk because of its recent experience in the area.

> We've had some good experience with incentive tolling in negotiations with producers in Alberta. Historically, costs were based on cost of volumes and it became fairly adversarial where it was in opposing interests in terms of estimating costs and estimating volumes. They tended to be adversarial and litigated and you came up with a solution.
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> We moved from that to looking at incentive tolling where the tolls are separated from the costs and trying to align the shippers with the pipeline companies. So, the results you were trying to obtain – that was how you were rewarded on the attainment of those.

MR. CARRUTHERS said Enbridge had the first pipeline in Canada to negotiate incentive tolling and it had good success. The first agreement was in 1995 for a five-year period. It was renegotiated in 2000 and is being renegotiated again. It has worked well reducing costs for both parties. A lot has been done with cost reduction and the renewed negotiations are focused on providing additional services. Flexibility is needed over time to realign.

MR. CARRUTHERS noted that work still needs to be done on the pipeline tariffs, which need to align with the strategy for commercialization of gas - how it would ramp up and what the shippers' needs are. While they have heard testimony today that shippers want predictability versus certainty, that's not consistent with his experience. Experienced companies are able to take more operating risk if they have confidence in their capabilities.

> There's a trade-off between project rating in terms of AA, AAA, B, whatever and the amount of equity risk that is being taken. So, it's not like [a company] can always go to one corner of the matrix and pick the lowest cost, because there is certainly more risk, which increases the need for returns and higher equity. As we progress through the design and development of the project, there certainly is a way we can align interests between the shippers and the companies building it.

REPRESENTATIVE BETH KERTTULA said his point about having incentives to control the capital costs is particularly important and asked what some of the incentives would be.

MR. CARRUTHERS replied that Alliance has the most current system.

MR. CRAWFORD related that the Alliance system was constructed on a contract that used 12 percent as a target rate of return realizing that at some point, there was a limit on what the rate of return could be.

REPRESENTATIVE KERTTULA asked him what the rate went up to.

MR. CRAWFORD remembered that it went up to 14 percent, but he would have to check.

REPRESENTATIVE KERTTULA asked how that was measured.

MR. CRAWFORD replied that it was pretty straightforward, but there has to be agreement on the initial estimate.

> When we were going through the open season, we had a capital cost that translated through a number of fixed factors into a rate that customers found reasonable. As long as that was reasonable, then in effect, the capital cost was reasonable. There was a recognition that to the extent that we spent more than what the capital costs were that the rate would be higher than what it would otherwise be, but not as high as it would be if the rate of return stayed the same. Likewise, if we had been successful in inflating the cost estimate and we came in under budget, then we would earn a higher rate of return, but all the shippers would see a lower rate than what they had signed up for in the first place. So, why worry as long as it was acceptable at the target rate? Then, there was a restraint on what ultimately could be considered a rate-based company in over-spending and incentives to minimize costs.

REPRESENTATIVE KERTTULA said that explanation was helpful and added the state has done something similar in some of its rate cases. However, the state has a lot more factors in determining the reasonableness of the costs all the way along rather than just saying it's set.